No. 9270

In the United States Circuit Court of Appeals for the Ninth Circuit

J. H. McCUNE, ALICE W. JACKSON, ALICE P. JACKSON, and FRED D. JACKSON,

Appellants,

vs.

FIRST NATIONAL TRUST AND SAVINGS BANK OF SANTA BARBARA, HORACE P. HOEFER, PETER DAVIDSON, CATHERINE DAVIDSON, and GEORGE GIOVANOLA, Trustee in Bankruptcy, of the Estate of Mortgage Securities, Inc., of Santa Barbara, a Corporation, Bankrupt,

Appellees,

and

J. H. McCUNE, ALICE W. JACKSON, ALICE P. JACKSON, and FRED D. JACKSON,

Appellants,

vs.

THOMAS J. SMITHERAM, E. W. SQUIER, and J. F. GOUX,

Appellees.

Appellees' Reply Brief

W. P. BUTCHER,
1010, State Street,
Santa Barbara, California,
Attorney for Appellees, First National Trust and Savings Bank, Horace P. Hoefer, Peter Davidson, Catherine Davidson, and George Giovanola, as Trustee.

W. P. BUTCHER and
STANLEY TOMLINSON,
Attorneys for Appellees, Thomas J. Smitheram, E. W. Squier, and J. F. Goux.

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ADDITIONAL STATEMENT OF FACTS

In the motion to dismiss the proceedings to set aside the order of adjudication and in the answer to the application to set aside the order of adjudication, the point was raised that it appeared that the order of adjudication was duly and regularly made on the 1st day of June, 1938, and the proceedings referred to Hugh J. Weldon, one of the Referees in Bankruptcy at his office at Number 15 West Carrillo Street, Santa Barbara, California, and thereafter at a meeting of the creditors of said bankrupt the said George Giovanola was elected and appointed trustee in bankruptcy of the estate of said bankrupt; that until the 20th day of April, 1939, the petitioners, J. H. McCune, Alice W. Jackson, Fred D. Jackson and Alice P. Jackson, were guilty of laches and unreasonable delay in failing to make their application questioning the validity of the order of adjudication. (Transcript of Record, pp. 61-65, pp. 70-74.)

Further, that it appears from the record (Transcript of Record, pp. 24-27) itself that the said J. H. McCune claims to be an assignee of the County National Bank and Trust Company of Santa Barbara of an alleged claim of said County National Bank and Trust Company of Santa Barbara against said bankrupt evidenced by certain promissory notes executed by said bankrupt to said bank; that Alice W. Jackson claims to be the assignee of a certain alleged claim of Winsor Soule against said bankrupt evidenced by a promissory note alleged to have been made by said bankrupt to the said Winsor Soule and that the claim of Fred D. Jack-

son and Alice P. Jackson is founded upon their ownership of certain preferred and common stock of the bankrupt corporation and that these petitioning creditors have not been prejudiced or damaged by said order of adjudication, and that the latter two have no interest in the matter.

The motion to dismiss further sets forth the ground that said petition to set aside the order of adjudication did not state facts sufficient to constitute grounds for vacating the order of adjudication because it did not appear on the face of the petition for involuntary bankruptcy that the Court did not have jurisdiction of said proceedings and to make its order for adjudication. The petition of Thomas J. Smitheram, E. W. Squier and J. F. Goux to intervene as petitioning creditors for the adjudication of said Mortgage Securities, Inc., of Santa Barbara as a bankrupt and to supplement the creditors named in said original petition set forth as exhibits to said petition their respective provable claims in bankruptcy. The claim of E. W. Squier and J. F. Goux annexed as Exhibit "A" to said last mentioned petition is founded upon legal services rendered by said claimants as attorneys for said bankrupt. The claim of Thomas J. Smitheram annexed as Exhibit "B" to said last mentioned petition is founded upon a deposit of money made with said bankrupt for the purchase of first mortgage certificates which were never delivered. These claims on their face appear to be valid, legal and provable claims in bankruptcy. (Transcript of Record, pp. 49-59.)

The question as to whether said intervening creditors had the right to petition and whether the Court had the power to permit them to file said petition and order them joined as petitioners for the adjudication of said Mortgage Securities, Inc., of Santa Barbara as a bankrupt will be discussed later in this brief. And if it appears that the original creditors were not disqualified as creditors in filing their petition for the adjudication then it will not become necessary for this Court to determine the rights of the intervening creditors except insofar as their right should be preserved in the event of any subsequent attack that may be made upon said order of adjudication.

"A"

POINTS AND ARGUMENT OF THE APPELLEES ON THE APPEAL FROM THE ORDER OF THE DISTRICT COURT DENYING THE PETITION OF THE APPELLANTS FOR AN ORDER VACATING THE ADJUDICATION IN BANKRUPTCY.

I.

The Claims of Horace P. Hoefer, Peter Davidson and Catherine Davidson Constituted Provable Claims and Were Not Claims Founded Upon an Unconstitutional Statutory Provision.

(a) The said claims of Horace P. Hoefer, Peter Davidson and Catherine Davidson originated in their

respective stockholders liability and in payment thereon in an action brought by the First National Trust and Savings Bank of Santa Barbara and the County National Bank and Trust Company of Santa Barbara, against the stockholders of said bankrupt founded upon promissory notes executed by said bankrupt to said banks, and the claims of said creditors are founded on contract.

The said creditors, Horace P. Hoefer, Peter Davidson and Catherine Davidson paid to the First National Trust and Savings Bank of Santa Barbara and the County National Bank and Trust Company of Santa Barbara their respective shares of their liability on a judgment obtained by said banks against them for their stockholders liability under the law of the State of California as it then existed. Upon that payment and under Section 322a of the Civil Code they had a direct and separate right of action against the said bankrupt, to recover the amount of their respective payments. Section 322a states that such creditor "shall be subrogated to the extent of such payment to the claim of the creditor against the corporation." Having a direct and primary right of action against the corporation said creditor has a provable and valid claim in bankruptcy against the corporation.

The obligation of the stockholder to pay his proportionate share of the debt of the corporation to a creditor is founded upon contract.

AUTHORITIES

Erickson v. Richardson, 86 F. (2d) 963;

Kaysser v. McNaughton, 57 Pac. (2d) 927; 6 Cal. (2d) 248;

In re Walker, 164 F. 680;

In re Brown, 164F, 673;

In re Remington Automobile & Motor Co., 119 F. 441.

(b) **The status of a stockholder is not that of a surety for the corporation. The liability of the stockholder for the corporation's debts is primary and independent, and that of a principal debtor.**

AUTHORITIES

Kaysser v. McNaughton cited, supra;

Trindade v. Atwater Canning Co., 128 Pac. 756;

Morrow v. Superior Court, 64 Cal. 383; 1 Pac. 354;

Nielson v. Crawford, 52 Cal. 248;

Sonoma Valley Bk. v. Hill, 59 Cal. 107.

(c) **The right given to the stockholder who has paid his proportionate share of liability under section 322a is fixed by statute.**

When a stockholder has paid his liability to a creditor he is discharged of his statutory liability and prior to the enactment of Section 322a he had no cause of action under the common law or by statute for reimbursement against the corporation. His payment likewise

discharges the debt of the creditor *pro tanto* against the corporation and by such payment the stockholder has a direct claim against the corporation for that portion of the debt.

AUTHORITIES

Dight v. Chapman, 44 Ore. 265; 75 Pac. 585;
In re Peerless Shoe Co., 226 F. 1020;
In re Bennett Shoe Co., 162 F. 691;
Bank of Mobile v. Zadek, 84 So. 715, 203 Ala. 518.

(d) The subrogation of the stockholder by virtue of 322a would work no unjust payment out of the assets of the insolvent corporation as between the creditor and the stockholder.

There is no relation of suretyship between a stockholder and the corporation and hence the case cited by counsel of a guarantor being placed upon an equal footing with a creditor as against the insolvent debtor is wholly beside the point. The creditor holding the claim against the insolvent corporation having received part of the payment of his debt could make claim for no more than the unpaid portion thereof as against the bankrupt corporation and would have to set forth the credit by way of payment made by the stockholder. The stockholder has a claim for so much of the debt that he has paid and the aggregate would amount, of course, to the total claim in the first instance and no

disproportionate distribution could be made of the assets of the bankrupt corporation because the creditor on the one hand could obtain no more than what would be due him for his unpaid balance and the stockholder on the other hand no more than what would be due him for the amount paid on the debt, and the same proportion of the assets would be paid as though the creditor had filed a claim for the full amount of his debt.

Counsel's reasoning that "the practical effect of allowing such subrogated creditors to share in the assets of the bankrupt estate before the claims of said banks had been paid in full, would be to take from said banks the rights which had vested in them prior to the enactment of Section 322a of the Civil Code of the State of California, being the right of recourse against all the assets of the corporation ahead of any right or claim of a stockholder who had paid a proportionate stockholder's liability," overlooks the fact that said banks have already been paid by the stockholders a part of their claims and have reduced the indebetdness of the corporation to said banks in the same proportion and that regardless of Section 322a the banks still have the right to have recourse against the assets of the corporation for their reduced claim and still have the same right to share proportionately in the assets of the corporation along with the stockholder who has already paid his proportion of the debt. There is no reason in justice or in equity why a creditor should have recourse for the full amount of his claim in and

to the assets of the corporation when he has received the benefit of part payment and deny the stockholder his right to recourse against the assets of the corporation for the benefit conferred by virtue of the amount that the latter has paid.

If the stockholder can be classed as a surety for the corporation and has paid part of his principal's debt, under the law he could have his claim against the bankrupt corporation.

AUTHORITIES

Sauve v. Fleschutz, 219 F. 542;
In re Salvator Brewing Co., 193 F. 989.

II.

Section 322a Is Constitutional.

The Section provides that the stockholder paying the corporation's debt because of statutory proportionate stockholder's liability shall be subrogated to the claim of the creditor against the corporation is not unconstitutional as impairing the obligation of contract between creditor and corporation or between stockholders themselves nor does the section violate any constitutional provision against restrospective legislation.

AUTHORITY

Patek v. California Cotton Mills, 4 Cal. App. (2d) 12, 40 Pac. (2d) 927.

III.

The Appellants Were Guilty of Laches by Their Failure to Attack the Order of Adjudication for Almost Ten Months.

A creditor moving to set aside an order of adjudication must make a plausible showing to the petition on the merits and must also furnish excusable explanation for not interposing the defenses in regular course within the time fixed by the bankruptcy. The burden was upon the petitioners to show in their petition facts sufficient to excuse the unreasonable delay in attacking the adjudication.

AUTHORITIES

In re Shell Metal Products, 19 F. Supp. 785;
Abbott Wauchuela Mfg. & Timber Co., 240 F. 938.

Laches may bar the objector's right to vacate the adjudication where lack of jurisdiction does not appear on the face of the proceeding. Jurisdiction attaches when the petitioners for the adjudication show they have "provable claims." As has been already stated the claims of the stockholders were not only "provable," but were "allowable." Hence no other jurisdictional defect appearing on the face of the record, the objecting petitioners have lost all right to attack the adjudication not only because of their failure to appear

within the statutory time and object but within a reasonable time thereafter.

AUTHORITIES

Mason v. Dean, 31 F. (2d) 945;
In re Worsham, 142 F. 121;
Alexander v. Farmer's Supply Co., 275 F. 824.

The petition of the objectors to the adjudication showing no sufficient excuse for delay, the District Court did not commit any error to refuse evidence to be introduced on the subject. At least, it is presumed that petitioners made out their strongest case for such excuse, which was merely that they had made certain objections before the Referee but apparently took no appeal from his adverse rulings.

IV.

The Only Person Who May Move to Vacate an Adjudication Is One Who Has a Subsisting Interest That May be Adversely Affected.

The petitioners, Fred D. Jackson and Alice P. Jackson base their right to attack on the fact that they are stockholders of the Mortgage Securities, Inc., of Santa Barbara. This appears on the face of their petition. Obviously they are rank outsiders unless they allege that they are injuriously affected by the adjudication, which they have not done.

The petitioners, J. H. McCune and Alice W. Jackson, are assignees of claims against the bankrupt but it nowhere appears that the adjudication will not benefit them. The corporation is admittedly insolvent, and the assets to be marshaled will be for the benefit of all creditors including petitioners. It is, therefore, to their advantage to allow the adjudication to stand. A creditor must show a benefit to him by vacating the adjudication. This petitioners have failed to do.

AUTHORITY

Abbott v. Wauchuela Mfg. Co., (cited supra).

V.

The Creditors, Thomas J. Smitheram, E. W. Squier and J. F. Goux Could at Any Time Intervene and Join in the Petition for Involuntary Bankruptcy.

While it may be a matter of discretion for the Court to permit such intervention, its power to do so under the Bankruptcy Act cannot be questioned.

Section 59, Subdivision (f) of the Chandler Act, which is substantially the same as it appeared in the Bankruptcy Act provides:

> "Creditors other than the original petitioners may *at any time* enter their appearance and join in the petition." (Italics, the writer's.)

It will be noted that the words "at any time" would give petitioners in intervention the right to appear

before an actual dismissal of the proceedings had taken place. In the proceedings filed by the petitioners to vacate the adjudication it is conceded that the order of adjudication has been made upon a petition filed in involuntary proceedings, and that the Court until the proceedings are dismissed has at least jurisdiction to test the validity of its own order of adjudication, and if the objecting petitioners have a right to attack such order other creditors should have the equal right to supplement any disqualified petitioning creditors. Furthermore, assuming that the Court should vacate the order of adjudication because of disqualified petitioning creditors the proceedings would then be in the same condition as before adjudication and the involuntary bankruptcy proceedings would still be pending, and the Court would be in exactly the same position as in the case where within the time allowed by statute, formal objections were filed before the hearing of the petition. In other words, the vacating of the order of adjudication would still leave the original petition in involuntary bankruptcy still pending and before it could be dismissed these petitioners on proper notice and motion, should have the right to join therein.

The words "at any time" are obviously not to be taken in an absolutely unlimited sense; there must at least be a petition pending before the Court, but creditors may join after the expiration of four months in order to make up the requisite number, even though the original creditors had no provable claims, or were insufficient in number, or had subsequently withdrawn.

Where the original petition was *formerly* sufficient, was in fact invalid because of the disqualification of some one or more of the petitioning creditors, nevertheless the original petition should be validated as of the commencement of the proceedings by the joinder of valid creditors, by subsequent intervening petition *filed before dismissal of the original* thereof even if such intervening joining petition is filed more than four months after the commission of the act of bankruptcy complained of.

And in this case this right of intervening creditors should be protected since the objecting creditors by their own laches and unreasonable delay have lulled other qualified creditors in a sense of security as to the validity of the adjudication and also barred said intervening creditors from any opportunity to intervene prior to adjudication and until the objection was raised at a time some ten months later.

AUTHORITIES

Remington on Bankruptcy, Vol. 1, Sec. 233 and Sec. 234;

In re Jemison Mercantile Co., 112 F. 966;

In re Koenig etc., 127 F. 891;

In re Bolognesi, 223 F. 771;

In re Vastbinder, 126 F. 417;

Canute Steamship Co. v. Pitts. & W. Virginia Coal Co., 263 U. S. 244, 44 S. Ct. 67, 68 L. Ed. 287.

It was not error of the District Court to refuse to receive evidence on the issues raised by the answer in that the District Court did not have to pass upon the allowability of Smitheram's claim since a creditor to qualify as a petitioner need only show that he had a provable claim and these facts appear on the face of the petition and the record does not show that the offer of proof would affect the provability of his claim.

Respectfully submitted,

W. P. BUTCHER,

Attorney for Appellees, First National Trust and Savings Bank, Horace P. Hoefer, Peter Davidson, Catherine Davidson, and George Giovanola, as Trustee.

W. P. BUTCHER,
STANLEY TOMLINSON,

Attorneys for Appellees, Thomas J. Smitheram, E. W. Squier, and J. F. Goux.